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JUL
JOHN T. FEY, Clerk

No. 272

IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

JESSE JOHNSON AND VIRGINIA D. JOHNSON, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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Jesse Johnson and Virginia D. Johnson, by their counsel, pray that a writ of certiorari issue to review the judgment entered in this case by the United States Court of Appeals for the Fourth Circuit.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 4-18) are reported at 24 T.C. 107. The opinion of the Court of Appeals, which has not yet been officially reported, appears in the Appendix, *infra*, pp. 26-31.

JURISDICTION

The judgment of the Court of Appeals (Appendix, *infra*, p. 32) was entered on May 25, 1956. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether a building contractor who lost $130,635.15 performing a construction contract for a Federal Housing Administration controlled corporation, in which the FHA held the preferred stock and he held the common stock, is entitled to deduct such loss for Federal income tax purposes when in its dominant position as preferred stockholder

(a) the FHA refused to allow any part of the loss to be passed to the corporation on the ground that it did not result in any economic benefit to it,

(b) the FHA held that the loss was the "hard luck" of the builder and required that it be borne solely by him, and

(c) the FHA refused to allow the loss to be treated as a contribution to capital for any purpose, i.e., for fixing rents or determining cost basis for income tax depreciation?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or Business Expenses.—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

* * * *

(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

(26 U.S.C. 1952 ed., Sec. 23)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(a)-1 Business expenses.—

Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business * * *. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. * * *

Sec. 29.23(e)-1 Losses by Individuals.—

Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, * * *

STATEMENT

Jesse Johnson's entire adult career has been devoted to carrying on his building contracting business for profit (R. 4, Appendix, *infra*, 27).

In 1946 Mr. Johnson and three other individuals organized Frederick Courts, Inc. under the laws of Virginia (R. 31-32). At the time of its incorporation Mr. Johnson and the three other individuals transferred real estate to Frederick Courts, Inc. having a cost price of $57,000.00 and each became the owner of one-fourth of the corporation's stock (R. 5).

Frederick Courts, Inc. proceeded with plans for the construction of an apartment development with funds to

be borrowed from the American Security and Trust Company, Washington, D. C., secured by a deed of trust covering all of its assets and insured by the Federal Housing Administration (R. 31). At this stage it was understood that Mr. Johnson would not be the builder of the Frederick Courts, Inc. development because, as the testimony shows, he was already proceeding with another project and "didn't want to get" himself "involved" in "too much work" inasmuch as he is "not as large an operator as some others" (R. 61-62). However, when "it came to almost the time to begin construction on" the Frederick Courts, Inc. project the other three stockholders wanted Mr. Johnson to do the building for only "the glory of doing it" and his response was that he "was in the building business, not for my health but for a profit" and thus refused to enter into a construction contract for this development without profit (R. 61-62). The result of this disagreement was that Mr. Johnson bought the stock of the other stockholders of Frederick Courts, Inc. and entered into a construction contract to build that corporation's apartment development with the express expectation of making a reasonable profit (R. 5, 23, 62).

In order to qualify for FHA insurance Frederick Courts, Inc. was required to amend its corporate charter in exact accordance with terms dictated by FHA (R. 31-39). Also, Frederick Courts, Inc. was required to issue all of its preferred stock to FHA (R. 8-9, 41). Further, Frederick Courts, Inc. was required by FHA to enter into a deed of trust on FHA Form No. 4187-B and Mr. Johnson was required to enter into a construction contract on FHA Form No. 2442-W (R. 43-51). The combined effect of the FHA charter amendment and the FHA required deed of trust and construction contract is such that for the 34 year period of the loan FHA, as preferred stockholder, is given complete domination and control of all funds, credit, tangible personal property, real property and rents, i.e., all assets of every nature owned or to be owned by Fred-

erick Courts, Inc. to the fullest extent that language could be employed to accomplish that purpose when used by the FHA staff of skilled draftsmen who had no other purpose in mind (R. 31-51).

For example, the FHA amendment to the corporate charter of Frederick Courts, Inc. provided, in part, as follows (R. 34-35):

> That the corporation shall not without the approval of the preferred stockholder "(a) assign, transfer, dispose of or encumber any real or personal property, including rents, except as specifically permitted by the terms of the mortgage, * * *"

The FHA dictated construction contract provided, in part, as follows (R. 46, 48-49):

> Jesse Johnson was "entitled to payment" only "in the amount approved by the Lender and the Federal Housing Commissioner with respect to" each application of said Jesse Johnson for payment under the construction contract. It was "further agreed by and between the parties hereto, that whenever it is provided in this Contract that the approval of, or the certificate or order from the Architect shall be received either as a condition precedent to any action being taken or not taken, as the case may be, or as a prerequisite to the exercise by the parties hereto of any right or rights hereunder, including the right to receive payment under this Contract, the Commissioner or the Lender may require that such approval and such certificate or order shall before being effective, be accompanied by the written approval of the Commissioner and the Lender or their duly authorized representatives."

In addition, the FHA required that Mr. Johnson furnish "an Indemnity Agreement in the amount of $116,364.00" to assure "completion of the project" (R. 52).

The FHA insured deed of trust on FHA Form No. 4187-B provided, in part, as follows (R. 43):

> That Frederick Courts, Inc. "will not voluntarily create or permit to be created against the property subject to this Deed of Trust any lien or liens inferior or superior to the lien of this Deed of Trust and further that it will keep and maintain the same free from the claim of all persons supplying labor or materials which will enter into the construction of any and all buildings now being erected or to be erected on said premises, and on the failure of the party of the first part to perform these covenants, or any part thereof, thereupon the principal and all arrears of interest shall, at the option of the holder of said note or any holder of the note secured by this Deed of Trust, become due and payable, anything contained herein to the contrary notwithstanding."

The FHA dictated construction contract entered into by Mr. Johnson on FHA Form No. 2442-W provided for a lump sum construction contract price of $1,163,640.00 (R. 45). Like all standard Government contracts this construction contract contained a "changes" provision whereby changes in Drawings and Specifications could be made in the course of construction with the approval of FHA and the American Security and Trust Company (R. 45).

Mr. Johnson's cost of performing the construction contract exceeded the original contract price by $280,635.15, making the total construction cost $1,444,275.15 (R. 10, 24; Appendix, *infra*, 28). $150,000 of such cost above the original contract price was incurred as a result of changes in specifications whereby "improvements in materials used and changes in the plans as originally approved by FHA resulted in increased cost of construction and would also provide increased income from apartments" (R. 9-10). FHA permitted the contract price to be increased to cover this $150,000 of expenditures that FHA determined resulted in an economic benefit to Frederick Courts, Inc. and these items are in no way involved in the instant case.

The remaining $130,635.15 of Mr. Johnson's costs above the original contract price were determined by FHA to

be attributable to delays due to bad weather and inability to secure materials which in no way increased the rental or economic value of the apartment project to Frederick Courts, Inc. (R. 62, et seq.). On the ground that this $130,635.15 did not increase the rental or economic value of the Frederick Courts, Inc. project the FHA took the position that it was Mr. Johnson's "hard luck" constituting his personal business loss that must be borne by him alone (R. 62-65). This flat refusal of the FHA to permit the contract price to be increased by the $130,635.15 so that a charge could be made to Frederick Courts, Inc. went even further and prohibited Mr. Johnson from taking any steps to treat the loss in question as a contribution to capital so that it would constitute a part of the capital structure of Frederick Courts, Inc. for the purpose of fixing rents and determining income tax depreciation (R. 62-65). The undisputed testimony with respect to the $130,635.15 loss here involved is as follows (R. 62-65):

> Q. What position did the FHA take with respect to the cost that you had incurred due to bad weather and inability to get materials?
>
> A. Well, they took the position that the excessive cost of the construction project, they didn't have anything to do with it, because it was just hard luck on my part that I didn't increase the rental value, economic value of the buildings, they wouldn't allow anything additional cost for the loans.
>
> • • •
>
> Q. Is it your understanding that the FHA did permit the construction contract to be increased to the extent that your excessive costs went to increase the value of the apartment project? Is that right, sir? And only to that extent? Is that what you are telling?
>
> A. It increased the value, but it couldn't increase the value to the extent the party lost. The only part that they estimate it increased.
>
> Q. The bad weather and the delays?
>
> A. That is right; did not increase the value of the building at all.

Q. They took the position that was your loss?

A. That is right.

Q. Have you ever tried to get them to include those in the apartment project?

A. Yes. Mr. Simmons and myself had an appointment down at the National Housing Office. I have forgotten the gentleman's name we talked to down there. They completely disallowed it. In fact, they sent us over to the Audit Division in the Motor Company Building upstairs. We had quite a conversation with the Chief Auditor of the Federal Housing Administration. He also said he didn't see how it could be allowed either, on the basis of depreciation.

* * *

Q. * * * In the course of the construction of Frederick Courts, Incorporated, what role, if any, did the FHA Inspector play out there?

A. The FHA Inspector was, of course, in charge of the construction, to see that the contractors met the obligation of inspection as to the specifications, and the constructing meeting the quality of the material and workmanship required.

Q. Did he approve the money you were paid under the contract?

A. Oh, yes, every month.

Q. In case of disapproval of any claim of yours, what did you do?

A. We had to take his figures on it. For instance, the first of every month, the FHA Inspector in charge of the job estimated the extent of the work completed during that month, in the prior month. Of course, we were paid on that basis.

Q. If you understood you could have gotten that $130,000 from Frederick Courts, Inc., why didn't you get it?

A. Why didn't I get the $130,000 for Fredericks Courts, Incorporated?

Q. Yes.

A. Because the Federal Housing Administration wouldn't allow it.

Q. Did they allow it in the rental basis for the apartments?

A. No, sir.

Q. Why didn't they?

A. They said the excess cost of the construction did not warrant the economic value, I believe.

Q. That it didn't increase the rental value of the apartments?

A. No, sir.

Mr. Johnson became insolvent as a result of this $130,635.15 loss (R. 25). Nevertheless, every effort of both Mr. Johnson and his attorney to have the loss passed on to the Frederick Courts, Inc. in any manner met with failure in the face of the FHA's flat and adamant refusal (R. 62-65). In view of the explicit charter and contractual provisions giving FHA, as preferred stockholder, domination and control of Frederick Courts, Inc. Mr. Johnson and his attorney had no alternative other than to concede that the $130,635.15 was irretrievably lost and could never be recouped in any manner. As a consequence of that situation Mr. Johnson deducted the $130,635.15 loss for Federal income tax purposes and disallowance of such deduction by the Commissioner of Internal Revenue has resulted in the $10,188.74 tax deficiency here involved.

The Tax Court sustained the Commissioner of Internal Revenue's disallowance of the loss on the ground that Frederick Courts, Inc. was "wholly owned" by Mr. Johnson and constituted his controlled "alter ego" with the result that the $130,635.15 loss was a contribution to capital and not deductible (R. 13-18). In reaching this conclusion The Tax Court overlooked the complete domination and control by FHA and the fact that Mr. Johnson's equity interest in Frederick Courts, Inc. was obviously

small and mistakenly relied upon *Higgins* v. *Smith*, 308 U.S. 473, 23 AFTR 800 (1940) and *Crown Cork International Corporation*, 4 T.C. 19 (1944) affd. 149 F. 2d 968 (CA 3 1945). In both of those cases the stockholders were in a position to have their corporations do their bidding without a dominant and controlling adverse preferred stockholder to prevent their doing so, which is the exact opposite of the situation in the instant case. Further, The Tax Court ignored the line of cases collated in *D. W. Pierce*, 41 BTA 1261 (1940)—acquiesced in as correct by the Commissioner of Internal Revenue—which were held to "point to the conclusion that outlays made by an owner-investor may not be considered capital contributions when they are paid to outsiders and engender only a secondary or indirect benefit for the capital invested." Also, The Tax Court and the Court of Appeals were of the opinion that they need not determine whether the $130,635.15 loss in question "produced true economic benefit to the" corporation (R. 17, Appendix, *infra*, 29).

The Court of Appeals ignored *D. W. Pierce*, *supra*, and adopted the "wholly owned" controlled "alter ego" position taken by The Tax Court in affirming its opinion with the added ground that if Frederick Courts, Inc. had constructed the apartment project for itself the $130,635.15 of excess cost would have been treated as capital investment rather than a loss (Appendix, *infra*, 29-30). The fallacy of the Court of Appeals' reasoning is two-fold:

First, the holding that Frederick Courts, Inc., which was under complete domination and control of FHA as preferred stockholder, was the "wholly owned" controlled "alter ego" of Mr. Johnson is in direct conflict with the opinions of this Court and other Courts. *Moline Properties, Inc.* v. *Commissioner of Internal Revenue*, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132, 30 AFTR 1291 (1943); *Sarner* v. *Mason*, 130 F. Supp. 829, aff'd 228 F. 2d 176 (CA-3, 1955); *Loftus* v. *Mason* and *Shirley-Duke Apartments* v. *Mason*, 130 F. Supp. 207 (February 10, 1956).

Further, the "wholly owned" controlled "alter ego" holding is contrary to the principles heretofore established by every court as controlling in the administration of Federal income taxation.

Second, if Frederick Courts, Inc. had constructed the apartment project for itself, the $130,635.15 would have been part of the capital structure of Frederick Courts, Inc. for all purposes, including the fixing of rents and determining of depreciation for income tax purposes, and thus would have been a basis for earnings and subject to recovery through depreciation, in the event such $130,635.15 contributed to the worth of the apartment project. *Wadsworth Manufacturing Co.* v. *Commissioner of Internal Revenue*, 44 F. 2d 762, 9 AFTR 441 (CA-6, 1930); *Rankin* v. *Commissioner of Internal Revenue*, 60 F. 2d 76, 11 AFTR 706 (CA-6, 1932). The opposite factual situation is presented here in that FHA finally and conclusively determined that the $130,635.15 did not go to Frederick Courts, Inc. in any manner and could not be a part of its capital structure for any purpose, thus making Mr. Johnson's "hard luck" loss definite, certain, and final without any opportunity for realizing any earnings thereon, directly or indirectly, or having any opportunity for recoupment. *Rankin* v. *Commissioner of Internal Revenue*, *supra*; *Wadsworth Manufacturing Co.* v. *Commissioner of Internal Revenue*, *supra*; *Loftus* v. *Mason* and *Shirley-Duke Apartments* v. *Mason*, *supra*; *Sarner* v. *Mason*, *supra*.

The Courts below expressed the view that had Mr. Johnson "wished he could undoubtedly have caused" Frederick Courts, Inc. "to establish additional accounts payable for the remainder of his excess costs which are now before us" (Appendix, *infra*, 29). This is in direct conflict with the holdings in the FHA "windfall" cases discussed below. This is also contrary to the evidence and it is obvious that both Mr. Johnson and his attorney devoutly wished to pass this loss on to Frederick Courts, Inc. in order to avoid insolvency. However, *when FHA*

refused to permit the construction contract price to be increased their cause was lost and there was simply *nothing to charge* to Frederick Courts, Inc. It is also clear that had any claim been made by Mr. Johnson against Frederick Courts, Inc. for this $130,635.15 loss without FHA approval it would have constituted the clearest kind of violation of the charter and contractual provisions giving FHA complete domination and control of the corporation in every respect material to the decision of this case.

The charter and contractual provisions make the FHA's domination and control of Frederick Courts, Inc. so complete that it is difficult to comprehend why it was thought that there could conceivably have been any effective means whereby Mr. Johnson could have passed the $130,635.15 loss on to the corporation in the face of the preferred stockholder's flat disapproval (R. 18-54). This domination and control of FHA over Frederick Courts, Inc. extends from the fixing of rents to the smallest detail and the testimony shows that Mr. Johnson "cannot move furniture out of the office, couldn't dispose of any equipment, venetian blinds, anything, carpeting, refrigerators" and has "no right to distribute dividends", making it perfectly clear that under the express terms of the charter and controlling contractual provisions he never had the kind of control of Frederick Courts, Inc. that would have enabled him to shift the $130,635.15 loss to that corporation without the preferred stockholder's approval as expressly stated in the charter and contractual provisions. (R. 22, 31-54).

The opinions below are inconsistent with the conclusions reached by the Courts in the FHA "windfall" cases. *Sarner* v. *Mason, supra*, and *Loftus* v. *Mason* and *Shirley-Duke Apartments* v. *Mason, supra*. The *Loftus* and *Shirley-Duke Apartments* case *involved charter and contractual provisions identical to those which gave FHA domination and control of Frederick Courts, Inc. in the instant case*. In the course of its opinion in that case the Court correctly pointed out that "*it is imperative through-*

out to remember that the charter is not the constitution of an independent corporation" and that it "must be constantly recalled, too, that the preferred stockholder is not just a shareholder" but "is a dominant creditor" who "reins the borrower through a charter fashioned for the purpose." The Court further pointed out that the "charter gives the preferred stockholder for the period of the insurance complete oversight of the corporation, its real and personal property, its revenues, and its disbursements" and constitutes "a broad, deliberate, and studied denial of the *jus disponendi* congenital in the corporation; and, again, we are reminded that the corporation is not an independent commercial entity" and "that without the approval of the preferred stockholder the corporation shall not assign, transfer, dispose of or encumber any of its property."

The holding in the windfall cases that FHA had complete domination and control is correct and the holding in the instant case is inconsistent and erroneous. The charter and contractual provisions giving domination and control of Frederick Courts, Inc. to FHA *were designed to prevent defaults and clearly were not operative only after default* as seems to be the view of the Court of Appeals below. Certainly the complete domination and control of Frederick Courts, Inc., by FHA is not lessened because Mr. Johnson and his attorney recognized that Frederick Courts, Inc. must submit to FHA's determination that the $130,635.15 loss was his "hard luck", that the loss in no way enhanced the economic or rental value of the apartment project, and that the loss could not be passed on in any manner to Frederick Courts, Inc.

REASONS FOR GRANTING THE WRIT

The instant case presents important and far-reaching problems which should be dealt with and decided by this Court. These problems have been erroneously decided below and the opinion of the Court of Appeals conflicts in

principle with decisions of this Court and with the decisions of Courts of Appeals for other circuits. The principles erroneously enunciated by the Courts below are of such importance that they should be reviewed by this Court for the following reasons:

1. Under no circumstances should judicial sanction be given to principles which permit a citizen to be whipsawed to his economic ruin between diametrically opposite holdings of two agencies of the Federal Government. That is what has been sanctioned below inasmuch as the holding of the FHA to the effect that the $130,635.15 loss was Mr. Johnson's "hard luck" and must be borne and absorbed by him still stands and the Commissioner of Internal Revenue's holding to the contrary that the $130,635.15 loss was a contribution to capital and not deductible has been sustained. Consequently, the situation presented here would clearly seem to call for the exercise of this Court's power of supervision to prevent such a departure from the accepted and usual standards of fairness followed in the administration of justice.

2. The opinions below holding that Frederick Courts, Inc. was the "wholly owned" controlled "alter ego" of Mr. Johnson are in direct conflict with the conclusion reached by the Courts in the FHA windfall cases of *Sarner* v. *Mason*, *supra*, and *Loftus* v. *Mason* and *Shirley-Duke Apartments* v. *Mason*, *supra*, to the effect that FHA as preferred stockholder had domination and control of the corporation. In *Sarner* v. *Mason*, *supra*, the Court of Appeals for the Third Circuit stated its position as follows:

> "As we have said, the Commissioner [of the Federal Housing Administration] is the sole preferred stockholder of the defendant corporations. The Federal Housing Administration therefore possesses the right to remove all the existing directors of the corporations and to elect new directors in their stead as provided by Paragraph Fifth (e) of the charters. The

suit filed by the plaintiffs to enjoin such action is without merit and cannot be maintained."

The direct conflict between the instant case and the FHA windfall cases cannot more clearly be shown than by quoting from the Court's opinion in *Loftus* v. *Mason* and *Shirley-Duke Apartments* v. *Mason*, *supra*, as follows:

> "In interpreting these clauses it is imperative throughout to remember that *the charter is not the constitution of an independent corporation. It must be constantly recalled, too, that the preferred stockholder is not just a shareholder.* The corporation is as much an instrument of F.H.A. as it is of its own sponsors and stockholders. Furthermore, the preferred stockholder is a *dominating* creditor, if not indeed the real and only standing creditor, of the borrower; the preferred stockholder has insured, to the mortgagee, the repayment in its entirety of a loan presumably *equal to 90% of the value of the corporation's total assets*—a heavy contingent liability, especially so in view of the high ratio of the loan to the security. The corporation is the focal point of the plan formulated and adopted by F.H.A. to accomplish the Congressional aim expressed in the National Housing Act. Instead of invoking contractual checks upon the borrower to safeguard F.H.A.'s liability, *the Commissioner reins the borrower through a charter fashioned for the purpose.* The Commissioner has followed the suggestion of the Act itself that:
>
> > '(1) The mortgaged property shall be held by a mortgagor approved by the Commissioner. The Commissioner may, in his discretion, require such mortgagor to be regulated or restricted as to rents or sales, charges, capital, structure, rate of return, and methods of operation. The Commissioner may make such contracts with, and acquire for not to exceed $100 stock or interest in any such mortgagor, as the Commissioner may deem necessary to render effective such restriction or regulation. * * *.'
>
> "To this end the Commissioner required the borrower to incorporate under a model and a single purposed charter which states the chief object of the in-

corporation to be the provision of housing for rent or sale and the obtaining of mortgage insurance from the Federal Housing Commissioner. *This charter gives the preferred stockholder for the period of the insurance, complete oversight of the corporation, its real and personal property, its revenues, and its disbursements.* Under its terms the only corporation funds or property distributable or alienable, except for operating costs, without the approval of the preferred stockholder are net earnings.

"The charter creates common stock consisting of 200 shares without par value. This was subscribed for and taken by the sponsors or builders of the project. The charter also establishes first preferred stock of 100 shares with a par value of $1.00 each and a dividend right of 5¢ per share annually. The Commissioner purchased all of the authorized preferred stock. That the other corporate articles straiten, as severely as we have stated, the privileges and powers ordinarily exercised by the directors and common stockholders of a corporation, is confirmed by a review of them.

"'So long as any property of this corporation is encumbered by a mortgage or deed of trust insured by the Federal Housing Commissioner, this corporation shall engage in no business other than the construction and operation of a Rental Housing Project or Projects', is the restriction appearing in the charter's declaration of the corporate purposes. The preferred stock is not redeemable before the termination of the mortgage insurance. No dividends can be paid, without the consent of a majority of the preferred and common stock outstanding, 'until all amortization payments due under the mortgage insured by the Federal Housing Commission have been paid' and the monthly reserve for replacements, required by the mortgage loan agreement, has been set aside. No disbursement of any kind from this reserve can be made without the consent of the preferred stockholder. Without such consent no rental can be fixed and no consolidation, merger, or voluntary liquidation is allowed.

"Of all the restrictions in the charter article V(a), supra, is the most comprehensive and effective. *It is a broad, deliberate, and studied denial of the jus disponendi congenital in the corporation; and, again, we*

are reminded that the corporation is not an independent commercial entity. The restriction is not confined to that personal property, real estate, and rent which are covered by the mortgage. Its reference to that instrument—'except as specifically permitted by the terms of the mortgage or deed of trust'—is merely to exempt the foreclosure powers from the force of V(a). It does not purport to exclude unmortgaged assets. Manifestly it does not ban operating expenditures, for they are indispensable to any operation at all of the corporation; clearly it does not outlaw dividends from net earnings, for that would conflict with an express authorization within the same charter. But with these exceptions it means precisely what it says—that *without the approval of the preferred stockholder the corporation shall not assign, transfer, dispose of or encumber any of its property.* Corroborative of this intention is the corporation's own inhibition, during the loan's term, against engaging in any other business or liquidating. This interpretation is also compelled by the purpose as well as by the letter of V(a); by this clause F.H.A. is simply again circumscribing the power of the corporation to draw off its money or alien its property.

"* * * Were the borrower a person and not a corporation, the result would not be different; for undoubtedly he would be restrained by contract just as the corporate borrower is now restrained by its charter. As the court sees it, the infirmity of the plaintiffs' position in this case is that they appraise the rights of the corporation and its common stockholders purely objectively, without regard to its peculiar status in the circumstances here." (Emphasis supplied)

The above conclusions in the windfall cases are in direct conflict with and are the exact opposite of the conclusions reached in the instant case. It is obvious that either the windfall cases or the instant case has been wrongly decided. We respectfully submit that the windfall cases are sound and that the principles there enunciated should be followed to the end that Mr. Johnson will not have another $10,188.74 tax deficiency loss imposed against him by the Commis-

sioner of Internal Revenue in addition to the $130,635.15 loss imposed against him by FHA, with wholly inconsistent and directly opposite grounds underlying the imposition imposed by each of the two Federal agencies. In any event, it would seem clear that this Court should deal with such a glaring conflict in order that it may be eliminated.

3. The rationale of the opinions below is that if the common stockholder having an obviously small, if any, equity interest above the amount of the FHA insured loan in a corporation dominated and controlled by the preferred stockholder carries on a business transaction with the corporation he must be taxed on any income but will not be allowed to deduct his business expenses because they must be deemed to constitute contributions to the capital of the corporation. This is a new and truly startling concept in Federal income taxation. We submit that its consequences will be disastrous if the principle becomes established in the tax law. Certainly such a principle should not be allowed to stand without review and full consideration by this Court.

Even assuming that Mr. Johnson's common stock equity ownership had been large and that domination and control of Frederick Courts, Inc. had been in him instead of FHA, Could he not, in the regular course of his building construction business, perform a construction contract, honestly and fairly negotiated, for that corporation without the disastrous consequence that all receipts constituted taxable income and all expenses constituted non-deductible contributions to capital? If that is to be the law we respectfully submit that it should be so declared by nothing less than this Court or the Congress.

4. The erroneous application made below of the principles stated by this Court in *Higgins* v. *Smith*, *supra*, is in conflict with the limits imposed by this Court upon the *Higgins* v. *Smith* doctrine as explained by the Court in *Moline Properties, Inc.* v. *Commissioner of Internal Reve-*

nue, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132 (1943). This Court has made it plain that the principle of *Higgins* v. *Smith* applies only where the corporate form "is a sham or unreal" and is not employed for a business purpose. *Moline Properties, Inc.* v. *Commissioner of Internal Revenue, supra.* Consequently, this Court should grant certiorari because the Court below has construed *Higgins* v. *Smith, supra*, in a manner directly conflicting with the construction that this Court required to be placed thereon as pointed out in *Moline Properties, Inc.* v. *Commissioner of Internal Revenue, supra.*

5. The view below that Mr. Johnson was acting in his capacity as a stockholder "alter ego" of the corporation or as an owner-builder to protect his $57,000 investment in the common stock of Frederick Courts, Inc. rather than in his capacity as a building contractor when he incurred the $130,635.15 loss here involved is based on principles so wide of the realities and results in such a distortion of the properly applicable tax consequences that the principles relied upon should be reviewed by this Court. Under the practical construction placed upon the contractual relationship of the parties, FHA insisted that no part of the $130,635.15 could in any manner be treated as a part of the capital structure of Frederick Courts, Inc. and Mr. Johnson and his attorney had no alternative other than to accept that practical construction. Clearly, inasmuch as Mr. Johnson was forced to agree with the dominant and controlling preferred stockholder that no part of the $130,635.15 went to Frederick Courts, Inc., directly or indirectly, there is no vestige of basis on heretofore understood principles for the holding that the $130,635.15 was a contribution to the capital of the corporation.

By acquiescing in the correctness of *D. W. Pierce, supra*, the Commissioner of Internal Revenue recognized that the opinion there correctly stated the principles involved as follows:

"We are called on to decide here whether the petitioner's payment of $24,506.46 on his guarantee of the indebtedness of his son is (1) a contribution to the capital cost of stock held by the petitioner which he sought to protect by his guarantee, (2) a gift to his son made when the business affairs of the son did not warrant a prudent loan, or (3) a loan made to his son, ascertained by the petitioner to be worthless in 1933 and charged off at that time.

"*The first position we consider untenable here. The amounts paid out on his guarantees by the petitioner did not go into the corporation to which it is contended capital contributions were made*, cf. *B. Estes Vaughan*, 17 B.T.A. 620; *Burns* v. *Commissioner*, 31 Fed. (2d) 399; certiorari denied, 280 U.S. 564; *In re Park's Estate*, 58 Fed. (2d) 965; certiorari denied, 287 U.S. 645, nor were they applied to the discharge of corporate obligations. See *J. S. Manbanles*, 20 B.T.A. 359; *W. F. Baringer*, 22 B.T.A. 1239; *Jeremiah G. Menihan*, 29 B.T.A. 169 aff'd. 79 Fed. (2d) 304; certiorari denied, 296 U.S. 651. Expenditures other than for these purposes which may in some indirect way improve the position of the petitioner's investment cannot be held contributions to capital under ordinary circumstances. *John P. Dillon*, 9 B.T.A. 177; *Seufert Brothers Co.* v. *Lucas*, 44 Fed. (2d) 528.

"In *George M. Wright*, 18 B.T.A. 471; aff'd. 47 Fed. (2d) 871, the stockholders of a corporation, among whom was the taxpayer, surrendered 50 percent of their stock holdings to the company's bankers pursuant to a plan by which the bankers agreed to refrain from placing the corporation in bankruptcy if one-half of the shares were surrendered to them to be paid over as compensation to the new management which they had secured for the company. We held that the value of the stock surrendered could not by virtue of the indirect benefit which came to taxpayer's remaining investment be labeled a contribution to capital and allowed its deduction as a loss. On largely similar facts we reached the same conclusion in *City Builders Finance Co.*, 21 B.T.A. 800. See also *First National Bank of Skowhegan, Maine*, 35 B.T.A. 876; *Robert Gaylord, Inc.*, 41 B.T.A. 1119. Cf. *Putnam Trust Co.*, 26 B.T.A. 655.

"*These holdings point to the conclusion that outlays made by an owner-investor may not be considered capital contributions when they are paid to outsiders and engender only a secondary or indirect benefit for the capital invested.* As we said in *City Builders Finance Co., supra*, at page 804:

> "'We believe that the situation here is that petitioner, impelled by the untoward exigencies confronting it, surrendered 321/2 shares of its stock * * * for which it received no direct compensation, and if any benefit of any kind inured to it, it was only the indirect benefit, as a stockholder, of having the corporation put in a more strategic position * * *.'

"The petitioner has testified that beside the more immediate objective of protecting the position of his son, he hoped by his guarantees to prevent the sale of the stock held as collateral in order to protect the price of similar securities held by him. Under the cases cited we think it plain that this benefit to petitioner's investment flowing indirectly from these outlays is not sufficient to render them contributions to capital." (Italics supplied)

Of course Mr. Johnson was acting in his capacity as a building contractor when he incurred the $130,635.15 loss under the stringent provisions of the FHA dictated construction contract which required a performance indemnity agreement of $116,364.00 and was daily subject to the strictest administrative supervision by FHA inspectors (R. 52, 63). Mr. Johnson's loss was paid in cash under the requirements of the FHA construction contract and was clearly deductible under the principles enunciated by this Court in *Helvering* v. *Price*, 309 U.S. 409, 84 L. Ed. 836 (1940).

6. The Court of Appeals' reliance upon its reasoning that if "the taxpayer had been constructing this building for himself, no one, we think, would contend that the excess cost due to unexpected weather conditions, rising labor costs, etc., could be treated as loss rather than as investment of capital" is in conflict with the opinions of this

Court and of other Courts of Appeals. The fallacy of this reasoning is as follows:

First, Mr. Johnson, whose entire career has been devoted to the building contracting business, and Frederick Courts, Inc. are separate taxable entities. *Moline Properties, Inc.* v. *Commissioner of Internal Revenue, supra.* In *Moline Properties, Inc.*, Mr. Justice Reed, speaking for this Court, succinctly stated the principles that should have been controlling below, as follows:

> "The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. New Colonial Co. v. Helvering, 292 U.S. 435, 442, 54 S. Ct. 788, 791, 78 L. Ed. 1348; Deputy v. Du Pont, 308 U.S. 488, 494, 60 S. Ct. 363, 366, 84 L. Ed. 416."

Second, in seeking to sustain its disallowance of the loss on the theory that Mr. Johnson and Frederick Courts, Inc. must be treated as one and the same "alter ego" the Court of Appeals stated that in *Wadsworth Manufacturing Co.* v. *Commissioner of Internal Revenue, supra*, it was held that excess cost of construction to the owner of a building was to be treated as capital investment and from this the conclusion was drawn that "No different rule, we think, is to be applied where the excess expenditure is made by the sole common stockholder of the corporation in completing the building at a cost above the amount called for by the contract which he has with it." That conclusion is squarely in conflict with *Moline Properties, Inc.* v. *Commissioner of Internal Revenue, supra.* Moreover, the Court of Appeals below completely missed the point of the *Wadsworth Manufacturing Co.* opinion which was based on the holding in that case that there was no showing that "the building was not

reasonably worth the entire sum expended in its construction." That this point was not taken into account by the Court below is clear from the fact that the Court considered it immaterial "whether" the $130,635.15 of "expenditures" involved as a loss here "produced true economic benefits to" Frederick Courts, Inc. Thus, again, the situation in the instant case is the exact opposite because here the FHA finally and conclusively determined that the $130,635.15 loss due to bad weather and inability to secure materials did not enhance the economic or rental value of the Frederick Courts, Inc. apartment project and, therefore, *the worth of the project did not include any part of the $130,635.15 loss.* Consequently, the correct rule that would have been applicable to Mr. Johnson had he in fact been the owner-builder was stated in *Rankin* v. *Commissioner of Internal Revenue*, 60 F. 2d. 76, 11 AFTR 706 (CA 6—1932) as follows:

> "The other question involved relates to wages paid to a mechanic while waiting to install a printing press. In 1924 the petitioner bought from a manufacturer a two-color printing press and employed a mechanic to install it. Some parts of the press were stolen, and it was necessary for petitioner to obtain new parts. While these parts were being manufactured a strike occurred in the plant of the company making them, and their delivery was delayed. Meanwhile for twenty-three days the mechanic was idle, and the petitioner was compelled to pay his wages and expenses. This amounted to $478.40 of the total paid for the installation, $555.69. The petitioner concedes that the wages paid for actually installing the press were properly capitalized, but insists that the wages and expenses of the mechanic while waiting should be deducted as an operating expense or loss. The Board of Tax Appeals held that these items should also be charged to capital assets upon the theory that it would be going too far to say that only the installation expenses ordinarily required should be capitalized.
>
> "While it is true it would be impractical to say that only the ideal costs of installation should be capitalized,

and that all costs exceeding what might reasonably be expected under normal conditions should be treated as a business expense or loss, yet where the costs arising from an unexpected contingency are as disproportionate to what is normally to be expected as those in this instance, it seems only fair to say that they should not be capitalized as a part of the improvement. We have been cited to no decision dealing specially with the question; but compare Zimmern v. Commissioner (C.C.A.) 28 F. (2d) 769; Atwater Kent Mfg. Co. v. Commissioner (C.C.A.) 43 F. (2d) 331, and Frank & Seder v. Commissioner (C.C.A.) 44 F. (2d) 147."

But it must be kept in mind that the basic conflict between the opinion of the Court of Appeals below and the opinions of this Court and of other Courts of Appeals lies in its conclusion that a common stockholder with a small equity interest in a corporation under complete domination and control by the preferred stockholder must be treated as one and the same "alter ego" as though he were the corporation owner-builder for tax purposes. This is the serious problem fraught with far-reaching consequences in the instant case and what would have been the tax results had the corporation in fact built its own apartment, without entering into a construction contract with a general contractor, is beside the point.

Unquestionably the Court of Appeals below has wrongly decided the instant case on newly established principles conflicting with the opinions of this Court and other Courts of Appeals. The principles established are utterly lacking in standards of fairness and present problems so serious to the sound administration of the tax laws with respect to those carrying on business in corporate form or doing business with corporations that certiorari should be granted by this Court.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

DAVID R. SHELTON
Munsey Building
Washington 4, D. C.
Counsel for Petitioners

July, 1956.

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7116.

JESSE JOHNSON and VIRGINIA D. JOHNSON, *Petitioners*,

versus

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION TO REVIEW THE DECISION OF THE TAX COURT OF THE UNITED STATES.

(Argued April 10, 1956. Decided May 25, 1956.)

Before PARKER, Chief Judge, DOBIE, Circuit Judge, and PAUL, District Judge.

David R. Shelton for Petitioners, and Meyer Rothwacks, Attorney, Department of Justice, (Charles K. Rice, Assistant Attorney General; Lee A. Jackson and I. Henry Kutz, Attorneys, Department of Justice, on brief) for Respondent.

PARKER, Chief Judge:

This is a petition to review a decision of the Tax Court of the United States affirming deficiency assessments of income taxes against petitioners, husband and wife, for the years 1947 and 1948, on the ground that certain deductions claimed as losses should not be allowed. The losses claimed

were expenditures made by the husband, whom we shall refer to hereafter as the taxpayer, in constructing a building under contract for Frederick Courts, Inc., a corporation in which he was the sole common stockholder. The question presented by the appeal is whether the Tax Court was wrong in treating these expenditures as capital contributions which increased the basis of taxpayer's stock in the corporation, instead of as losses sustained by him under his construction contract with it. A similar question was presented to the Tax Court and decided against taxpayers in the decision under review in connection with expenditures made by the husband under a contract with Parkwood, Inc., another corporation in which he was the sole common stockholder. Taxpayers do not ask a review of that part of the decision relating to Parkwood, however, contending that the Parkwood expenditures are to be distinguished from the Frederick Courts expenditures on the basis of control exercised over Frederick Courts by the Federal Housing Administration as a preferred stockholder.

The facts were fully stated in the decision of the Tax Court and need not be repeated in detail here. See 24 T. C. 107. They may be briefly summarized as follows: Taxpayer is engaged in the construction business. In 1946 he and three other individuals organized Frederick Courts and transferred to it real estate worth $57,000. In May of the following year, he acquired all of the stock of the corporation and, in anticipation of applying for F. H. A. loan, amended its charter to provide for the issuance of preferred stock. Subsequently, preferred stock was issued to the F. H. A. which gave it certain rights of control over the affairs of the corporation for the protection of its interests with respect to the loans which it had guaranteed, and with right to take over complete control of its affairs in case of default.* Otherwise, complete control of the

* The amended corporate charter gave the holder of the preferred stock (F. H. A.) control over dividends, reserve fund for replacements, transfers, assignments or any action affecting the

corporation's affairs was left in its officers and directors, who were selected by taxpayer, its sole common stockholder, from among his employees. No defaults have occurred which would authorize the preferred stockholders to take over control of the corporation and there has never been any effort on the part of F. H. A. to interfere with its control by its officers and directors.

Taxpayer entered into a contract with the corporation to construct for it an apartment building, the construction of which was being financed by loans guaranteed by the F. H. A. The original cost of construction under this contract was to be $1,163,640; but this was increased with the approval of F. H. A. to $1,313,640. Taxpayer's expenditures in constructing the building, however, amounted to $1,444,275.15, which was $130,635.15 in excess of the amount provided by the amended contract. Part of this excess was attributable to bad weather, rising labor costs and inability to get materials during the construction period. The F. H. A. refused to sanction an increase in the value of the building which would have enabled the corporation to secure additional loans to reimburse the taxpayer for this excess, and the taxpayer did not attempt to have the corporation credit him with the excess among accounts receivable, to be paid if and when it had funds available for that purpose, as was done in the case of Parkwood. Taxpayer claimed the excess as an ordinary loss on his returns for 1947 and 1948. The Commissioner disallowed the deductions and the Tax Court affirmed his action, holding that

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corporation's interest in its property, over terms of rental, physical alterations in the mortgaged premises, and changes in the corporate charter as well as over mergers, consolidations and liquidations, so long as the preferred stock remained outstanding, which would be as long as the mortgage indebtedness remained unpaid. The charter also provided for keeping of records by the corporation with right of inspection of records and property by the Federal Housing Commissioner and for vesting of complete control in F. H. A. in the event of default by the corporation in respect of any obligation assumed by it.

the excess construction costs were capital contributions by taxpayer to the corporation in which he was the sole common stockholder. The basis of its decision is contained in the following portion of its opinion:

> "The corporations were clearly his alter ego since their officers and directors, elected by him were all individuals employed by him in his contracting business in various subordinate capacities. When he found that his costs were in excess of the contract price, he caused the corporations to increase the contract price. Frederick Courts, Inc., was able to obtain an additional loan of $102,100, and voted petitioner $100,000 of this immediately. Subsequently, petitioner was voted $50,000 by Frederick Courts, Inc., and $96,372.80 by Parkwood, Inc., such sums being payable 'when funds are available.' Had petitioner wished, he could undoubtedly have caused the corporations to establish additional accounts payable for the remainder of his excess costs which are now before us. Having failed to do so, he must be regarded as having made additional contributions to the capital of each of the corporations, and the amount of the excess costs is to be added to his basis for the stock.
>
> "Since the corporations were petitioner's alter ego and the transactions herein were not at arm's length, it is immaterial whether the excess costs were due to the use of more expensive materials than required by the specifications, rising labor costs, or bad weather conditions. We need not determine whether all such expenditures produced true economic benefits to the corporations. For, whatever their economic value, the excess expenditures over the amended contract prices were, on the facts of this case, capital contributions which increased the basis of petitioner's stock."

We think that the Tax Court was correct in its decision. If the taxpayer had been constructing the building for himself, no one, we think, would contend that the excess cost due to unexpected weather conditions, rising labor costs, etc., could be treated as loss rather than as investment of capital. By sec. 24(a)(2) of Title 26 of the Code it is

expressly provided that "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate" shall not be allowable as a deduction. And in *Wadsworth Mfg. Co.* v. *Com'r* 6 Cir. 44 F. 2d 762, it was held that excess cost of construction to the owner of a building, due to a contractor's default, was to be treated as capital investment and not as loss. No different rule, we think, is to be applied where the excess expenditure is made by the sole common stockholder of the corporation in completing the building at a cost above the amount called for by the contract which he has with it. As said by the Tax Court, the corporation is his alter ego. Cf. *Higgins* v. *Smith*, 308 U. S. 473. In the case before us, taxpayer manifestly made the expenditures, not because as contractor he could be held to the terms of the contract, but because as sole common stockholder of the corporation it was to his interest and the corporation's interest that the building be completed. Because of conditions that had arisen, he was simply putting more into completing the building than originally contemplated; and this is manifestly not loss but capital investment. If the corporation had made the expenditure there would have been no question as to this. *Wadsworth Mfg. Co.* v. *Com'r*, *supra*. We think it equally clear when the expenditure was made by the sole common stockholder.

We agree with the Tax Court that the holding of preferred stock by the F. H. A. and the right to take over and control the corporation in case of default does not affect the matter. There had been no default and the F. H. A. had not taken control. With respect to the minor limitations relating to rentals, keeping of records, inspection, etc., these were no more than safeguards of the mortgage indebtedness. They did not substantially interfere with the corporation's control of its activities, and furnish no basis for the contention that taxpayer in the performance of the construction contract was dealing at arm's length with the corporation. The expenditures involved were made by tax-

payer just as they would have been made by him if there had been no right of control under any circumstances in F. H. A., i.e. for the completion of the building which would add to the value of his holdings of common stock. With respect to this matter the Tax Court said:

> "In the instant case, petitioner argues that he lacked complete control over the corporations because of the rights and powers of the Federal Housing Administration as guarantor of the corporations' mortgages. However, after an examination of the various agreements entered into it is obvious that petitioner retained complete control over the corporations' activities. The Federal Housing Administration held no stock in Parkwood, Inc., and, as to Frederick Courts, Inc., only if that corporation had defaulted on the payment of its mortgage would the Federal Housing Administration have been given control over its activities. The sole exception appears to be that the Federal Housing Administration had certain powers with respect to the disbursement of the guaranteed loans. This fails to support petitioner's argument, since he received almost the entire amount of such loans and his complaint is that there were not more of them."

There was no error and the decision of the Tax Court will be affirmed.

Affirmed.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7116.

JESSE JOHNSON and VIRGINIA D. JOHNSON, *Petitioners*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION to Review the Decision of The Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decision of the said The Tax Court of the United States, in this cause, be and the is hereby, affirmed.

JOHN J. PARKER
Chief Judge, Fourth Circuit.

ARMISTEAD M. DOBIE
United States Circuit Judge.

JOHN PAUL
United States District Judge.

Filed: May 25, 1956

R. M. F. WILLIAMS, JR.
Clerk

(SEAL)

A true Copy,
Teste:

RICHARD M. F. WILLIAMS, JR.
Clerk of the United States Court of Appeals for the Fourth Circuit.

In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 272

JESSE JOHNSON AND VIRGINIA D. JOHNSON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and the opinion of the Tax Court (R. 4–18)[1] are reported at 24 T. C. 107. The opinion of the Court of Appeals (Pet. 26–31) is reported at 233 F. 2d 752.

JURISDICTION

The judgment of the Court of Appeals (Pet. 32) was entered on May 25, 1956. The petition for a writ of certiorari was filed on July 23, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

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[1] Record references are to the appendix to the petitioners' brief filed in the Court of Appeals.

QUESTION PRESENTED

The taxpayer, a builder, owns all of the common stock of a corporation for whom he contracted to construct an apartment project. The taxpayer's expenditures in connection with the project exceeded the amount (obtained by loans insured by the Federal Housing Administration) which the corporation agreed to pay him pursuant to the contract between them. The question presented is whether the Court of Appeals, affirming the Tax Court, correctly held that the taxpayer's expenditures in excess of the contract price were in substance capital contributions which increased the basis of his stock in the corporation and thus were not losses within the meaning of Section 23 (e) (1) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

Sections 23 (e), 113 (b), and 117 (b) of the Internal Revenue Code of 1939, and Section 29.23 (e)-1 of Treasury Regulations 111, are printed in the Appendix, *infra*, pp. 9–11.

STATEMENT

The facts, as found by the Tax Court (R. 4–13) and summarized by the Court of Appeals (Pet. 27–29), are as follows:

Jesse Johnson (referred to as the taxpayer) and Virginia D. Johnson, his wife, filed joint income tax returns for 1947 and 1948 in which certain excess construction costs, more particularly described below, were claimed as ordinary losses in the respective

amounts of $13,878.82 and $116,756.33, or a total of $130,635.15. (R. 4, 10.)

The taxpayer was engaged in the construction business. In 1946, he and three other individuals organized Frederick Courts, Inc., for the purpose of constructing an apartment development, and transferred to it real estate worth $57,000. In May of the following year, the taxpayer acquired all of the stock of the corporation. (R. 5; Pet. 27.)

In anticipation of an application for a loan to be insured by the Federal Housing Administration (referred to as F. H. A.), the corporation's charter was amended to provide for the issuance of preferred stock. The amended corporate charter gave F. H. A., the holder of the preferred stock, certain rights of control—so long as the mortgage indebtedness remained unpaid—over dividends, reserve fund for replacements, transfers, assignments or any action affecting the corporation's interest in its property, over terms of rental, physical alterations in the mortgaged premises, and changes in the corporate charter, as well as over mergers, consolidations, and liquidations. The charter also provided for keeping of records by the corporation with right of inspection of records and property by the Federal Housing Commissioner and for vesting of complete control in F. H. A. in the event of default by the corporation in respect of any obligation assumed by it. Otherwise, complete control of the corporation's affairs was left in its officers and directors, who were selected by the taxpayer, its sole common stockholder, from among his employees. (Pet. 27–28; R. 5–8.)

No defaults occurred which would authorize the preferred stockholder to take over actual control of the corporation, and there was never any effort on the part of the F. H. A. to interfere with its control by its officers and directors. With respect to the limitations relating to rentals, keeping of records, inspection, etc., they did not substantially interfere with the control of the corporation's activities. (Pet. 28, 30.)

The taxpayer entered into a contract with the corporation to construct an apartment building for it. The construction was to be financed by loans guaranteed by the F. H. A. The original cost of construction under the contract was to be $1,163,640. With the approval of the F. H. A., it was increased to $1,313,640. However, the taxpayer's expenditures in constructing the building amounted to $1,444,275.15 or $130,635.15 in excess of the amount provided by the amended contract. Part of the excess was attributable to bad weather, rising labor costs, and inability to get materials during the construction period. The F. H. A. refused to sanction an increase in the value of the building which would have enabled the corporation to secure additional loans to reimburse the taxpayer for this excess, and the taxpayer did not attempt to have the corporation credit him with the excess among accounts receivable to be paid if and when it had funds available for that purpose. (Pet. 28.)[2]

[2] This procedure was followed with respect to other excess expenditures. Thus, at a meeting of the board of directors on July 26, 1948, after the construction of the apartment project had been completed, the taxpayer presented a bill of $50,000 for extras to

In sustaining the Commissioner's disallowance of the claimed deductions, and in holding that the excess expenditures were capital contributions by the taxpayer to the corporation in which he was the sole common stockholder, the Tax Court found that the corporation was the taxpayer's alter ego and that the transactions between them were not at arm's length. The Court of Appeals agreed. It further found that the taxpayer had made the expenditures in question, not because as contractor he could be held to the terms of the contract, but because as sole common stockholder of the corporation it was to his interest (as well as to the corporation's) that the building be completed. (Pet. 28–30.)

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the corporation, additional to the excess expenditures here involved. The board authorized the corporation "to make payments on account of this bill when funds are available", and thus increased the contract price by that amount. All or most of this $50,000 was paid to the taxpayer by 1950. (R. 10.)

A similar account receivable in the amount of $96,372.80 had been set up in connection with excess expenditures incurred by the taxpayer in the construction of an apartment project for Parkwood, Inc., another wholly owned and controlled corporation. In the Tax Court, the taxpayer had asserted that in addition to the claimed loss with respect to the Frederick Courts, Inc., venture, he had also suffered a loss of $15,621.32—the excess of expenditures over the construction contract price agreed upon between him and Parkwood, Inc. The Tax Court held that this amount, too, was not deductible as an ordinary loss but was part of the taxpayer's cost basis of his stock in that corporation. The judgment with respect to the Parkwood, Inc., phase of the case was not appealed. The taxpayer contended below that the Parkwood, Inc., expenditures are to be distinguished from the Frederick Courts, Inc., expenditures on the basis of the alleged control exercised over Frederick Courts, Inc., by the F. H. A. as a preferred stockholder. (R. 10–12; Pet. 27, 28.)

ARGUMENT

1. The court below, affirming the Tax Court, held that the taxpayer's expenditures in excess of the amount provided for in the contract between himself and Frederick Courts, Inc., whose common stock he owned in its entirety, constituted capital contributions which increased the basis of his stock in the corporation, and were not deductible losses within the meaning of Section 23 (e) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 9). This decision is correct and embodies a proper application of well-established principles.

Both the Tax Court and the Court of Appeals agreed that the corporation was the taxpayer's alter ego, and that the transactions entered into between the two were not at arm's length. In the circumstances, and looking through form to substance (cf. *United States* v. *Cumberland Pub. Serv. Co.*, 338 U. S. 451, 454; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473, 476; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609, 613–614; *Griffiths* v. *Commissioner*, 308 U. S. 355), both courts properly found that the expenditures in question were made to benefit the taxpayer as owner of the corporation, and not as a contracting party with it (cf. *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, 289, fn. 5). The concurrent factual findings of the two courts are conclusive here. *Comstock* v. *Group of Investors*, 355 U. S. 211, 214.

The taxpayer's contrary argument is based on the hypothesis that the F. H. A. was in control of the corporation by virtue of its ownership of the preferred stock. That hypothesis is untenable. True,

the amended corporate charter did give the F. H. A. certain rights as the holder of the preferred stock. But insofar as control over the corporation was concerned, these constituted, as the court below pointed out (Pet. 30), only "minor limitations relating to rentals, keeping of records, inspection, etc., * * * [and] were no more than safeguards of the mortgage indebtedness." In all other respects, as the Court of Appeals concluded (Pet. 27–28)—

> complete control of the corporation's affairs was left in its officers and directors, who were selected by taxpayer, its sole common stockholder, from among his employees. No defaults have occurred which would authorize the preferred stockholders to take over control of the corporation and there has never been any effort on the part of F. H. A. to interfere with its control by its officers and directors.

For all practical purposes, effective control of the corporation remained in the taxpayer throughout the period in question.

2. There is no conflict of decisions. *Sarner* v. *Mason,* 228 F. 2d 176 (C. A. 3d), certiorari denied, 351 U. S. 924, is distinguishable on its facts and indistinguishable in principle from the instant case. In *Sarner,* it was held that the Commissioner of the F. H. A., the holder of all of the preferred stock of the corporations involved, could not be enjoined from removing existing directors and appointing new directors. The F. H. A.'s control over the corporations in that case was explicitly grounded upon three separate defaults by the borrowing corporations under the terms of the certificates of incorporation: (1)

they had unauthorizedly redeemed common stock; (2) they had made certain unapproved long-term loans; and (3) they had refused to furnish information and data requested by the F. H. A. Here, however, there were no defaults which would have authorized similar action by the F. H. A., and, indeed, the F. H. A. made no effort to interfere with the control of the corporation by its officers and directors. (Pet. 28.)

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
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AUGUST 1956.

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(c) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) For expenditures, receipts, losses, or other items, properly chargeable to capital account * * *.

* * * * *

(26 U. S. C. 1952 ed., Sec. 113.)

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) [As amended by Sec. 150 (c), Revenue Act of 1942, c. 619, 56 Stat. 798] *Percentage Taken into Account.*—In the case of a taxpayer other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(26 U. S. C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23 (e)–1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (*a*) incurred in the taxpayer's trade or business, or (*b*) incurred in any transaction entered into for profit, or (*c*) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (*d*) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23 (g) and 117, relating to capital losses; section 23 (h), relating to wagering losses; section 24 (b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United

States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113 (b).
* * *

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U. S. GOVERNMENT PRINTING OFFICE: 1956

FILED
SEP 5 1956
JOHN T. FEY, Clerk

No. 272

IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

JESSE JOHNSON and VIRGINIA D. JOHNSON, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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REPLY BRIEF FOR THE PETITIONERS

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REPLY BRIEF FOR THE PETITIONERS

Upon analysis it will be seen that the brief for respondent in opposition to petition for a writ of certiorari in the instant case accentuates the importance of granting the writ and clearly discloses the fact that the opinion below is in direct conflict with decisions of this Court and with decisions of Courts of Appeals for other circuits.

1. The opposition brief relies upon *United States* v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451, 94 L. Ed.

251, 38 AFTR 978 (1950), *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 89 L. Ed. 981, 33 AFTR 593 (1945), *Higgins* v. *Smith*, 308 U.S. 473, 84 L. Ed. 406, 23 AFTR 800 (1940), *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 82 L. Ed. 474, 19 AFTR 1258 (1938) and *Griffiths* v. *Commissioner*, 308 U.S. 355, 84 L. Ed. 319, 23 AFTR 784 (1939). In those cases the stockholders had full control of the corporations and were in a position to require the corporate entities to do their bidding without a dominant and controlling adverse preferred stockholder to prevent their doing so, which is the opposite of the situation in the instant case. In each of those cases the basic question was whether the corporate entities had been used by their controlling stockholders as a sham for no business purpose in order to avoid taxation. Surely those cases can have no bearing in the instant case which involves a Federal Housing Administration dominated and controlled corporation designed "to accomplish the Congressional aim expressed in the National Housing Act" which "corporation is not an independent commercial entity". *Loftus* v. *Mason* and *Shirley-Duke Apartments* v. *Mason*, 139 F. Supp. 207 (1956) and *Sarner* v. *Mason*, 228 F. 2d 176 (CA 3, 1955) cert. denied 351 U.S. 924, 100 L. Ed. 600 (1956).

2. The opposition brief does not mention *Moline Properties, Inc.* v. *Commissioner of Internal Revenue*, 319 U.S. 436, 87 L. Ed. 1499, 30 AFTR 1291 (1943) relied upon in the petition for certiorari. The opinion below is in direct conflict with the opinion of this Court in *Moline Properties, Inc.* and under the principles there established it is perfectly clear that Frederick Courts, Inc., dominated and controlled by FHA as preferred stockholder, is not the alter ego of Jesse

Johnson who performed a construction contract for that corporation—dictated in every detail by FHA—in the regular course of his life-long business as a builder.

3. The opposition brief does not mention *Loftus* v. *Mason* and *Shirley-Duke Apartments* v. *Mason, supra,* in which the opinion, *dealing with identical charter and contractual provisions,* makes it perfectly plain that the position taken below is in direct conflict with the FHA windfall cases.

4. The attempted distinction with respect to *Sarner* v. *Mason, supra,* mistakenly *confuses the wrongful power to violate legal rights with legal rights themselves.* Even assuming that Mr. Johnson could have surreptitiously increased the contract price to cover his loss as a builder and made a charge against Frederick Courts, Inc., such wrongful act would clearly have constituted a violation of the FHA dictated charter and contractual provisions subjecting both Mr. Johnson and Frederick Courts, Inc. to the consequences thereof. Obviously in imposing the charter and contractual provisions here involved it was the purpose of FHA to prevent such wrongful violations and inasmuch as FHA and Mr. Johnson recognized that he had no legal right to pass his "hard luck" $130,635.15 loss on to Frederick Courts, Inc. it was properly deductible under the Internal Revenue Code.

5. The opposition brief does not mention *Wadsworth Manufacturing Co.* v. *Commissioner of Internal Revenue*, 44 F. 2d 762, 9 AFTR 441 (CA 6, 1930) and *Rankin* v. *Commissioner of Internal Revenue*, 60 F. 2d. 76, 11 AFTR 706 (CA 6, 1932) from which it is clear that the opinion below is in direct conflict with

the principles established by the Court of Appeals in those cases.

6. Just as FHA authorized the construction contract price in the first instance, the opposition brief recognizes that "With the approval of the F.H.A., it was increased" by $150,000, i.e., from $1,163,640 to $1,313,640 (p. 4) to cover improvements in materials which FHA recognized as increasing the economic and rental value of the apartment project. The brief also recognizes that FHA *refused to sanction* any contract price increase to cover the $130,635.15 loss here involved which was determined by FHA to have not resulted in any economic benefit to Frederick Courts, Inc. In its footnote on pages 4 and 5 the brief then, however, seems to contend that because $100,000 of the FHA *authorized* increase was paid through additional insured loan and the remaining $50,000 of the FHA *authorized* increase was charged to be paid "when funds are available" Mr. Johnson should have taken steps to charge the *unauthorized* $130,635.15 loss also. This reasoning is worse than a *non sequitur*. The *opposite* conclusion follows therefrom inasmuch as it is clear that without an *authorized* contract price increase there was simply nothing that could properly be charged to Frederick Courts, Inc.

7. The opposition brief does not mention the fact that after reviewing the Court of Appeals' opinions on the subject it was held in *D. W. Pierce*, 41 BTA 1261 (1940) that the authorities "point to the conclusion that outlays made by an owner-investor may not be considered capital contributions when they are paid to outsiders and engender only a secondary or indirect benefit for the capital invested". *D. W. Pierce, supra,*

was acquiesced in by the Commissioner of Internal Revenue as correctly stating the principles involved.

8. There is clearly nothing in *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 82 L. Ed. 1346, 20 AFTR 1269 (1938) or *Comstock* v. *Group of Investors*, 335 U.S. 211, 92 L. Ed. 1911 (1948) that militates against petitioners' position. Footnote 5 in *Helvering* v. *National Grocery Co., supra*, relied upon in the opposition brief, deals with fraud, profit motive, and planned avoidance of taxation by foreign corporations and does not have the remotest bearing here. This Court's five to four opinion in *Comstock* v. *Group of Investors, supra*, supports petitioners because the "legal import" of the "unchallenged facts" shows error below with exceptional clarity.

9. Most important of all, the opposition brief does not mention the fact that judicial sanction has been given below to principles which permit a citizen to be whipsawed to his economic ruin between diametrically opposite holdings of two agencies of the Federal Government. FHA's holding that the $130,635.15 loss was Jesse Johnson's "hard luck" to be borne and absorbed by him resulted in Mr. Johnson's insolvency. The Commissioner of Internal Revenue's holding to the contrary sustained below adds the $10,188.74 tax deficiency here involved to Mr. Johnson's economic disaster. This situation calls for the exercise of the Court's power of supervision to prevent such an unwarranted departure from the accepted and usual standards of fairness followed in the administration of justice.

CONCLUSION

For the reasons stated above and in the petition, it is respectfully submitted that the petition for a writ of certiorari should be granted.

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September 1956.